

Client Alert

Corporate Department

June 20, 2008

Use of Swaps By Hedge Funds May Accelerate Section 13(d) Filing Obligations Following U.S. District Court (S.D.N.Y.) Decision

On June 11, 2008, the United States District Court for the Southern District of New York issued an opinion with potentially far-reaching ramifications regarding the use of equity swaps by activist shareholders to build ownership positions in their portfolio companies. In *CSX Corporation v. The Children's Investment Fund Management (UK) LLP* ("TCI"), et al., Judge Lewis A. Kaplan ruled that TCI violated applicable securities laws by failing to timely disclose in a Schedule 13D its investment in CSX through total return equity swaps. Following a fact specific analysis, the Court concluded that TCI beneficially owned the shares underlying the equity swaps as they were used with the purpose and effect of preventing the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements of Section 13(d) of the Exchange Act.

The violations of securities laws alleged by CSX to have been committed by TCI, as well as 3G Capital Partners ("3G"), occurred in the context of an election contest commenced by the two hedge funds against CSX with respect to its 2008 annual meeting of shareholders. TCI began to build a position in CSX in October 2006 and eventually formed a Section 13(d) group with 3G for the purpose of running a proxy contest in support of their slate of directors for election at the 2008 annual meeting. TCI used equity swaps to build its position in CSX, at one point obtaining an economic interest in close to 14% of CSX's outstanding shares. Later, in a joint Schedule 13D, the two hedge funds disclosed direct ownership of approximately 8% of CSX's outstanding shares and equity swaps referencing an additional 12% of CSX's outstanding shares. CSX filed suit, claiming, among other things, that the

two hedge funds used equity swaps as leverage to influence management while failing to publicly disclose their true position in the company in a Schedule 13D.

TCI argued that it did not beneficially own the shares underlying the equity swaps under the "beneficial ownership" definition of Rule 13d-3(a) as TCI did not directly or indirectly have the legal right to vote or dispose of those shares. This was essentially the position taken by the SEC's

Division of Corporation Finance in an *amicus* letter submitted to Judge Kaplan. CSX argued that TCI beneficially owned the shares held by the counterparties to the swaps because TCI had voting and/or investment power over such shares by virtue of the counterparties having an economic incentive to vote, dispose or take other action with respect to the shares that would be favorable to TCI. The SEC disagreed, stating that such an economic incentive is not sufficient to create beneficial ownership and that there must be "actual authority" to vote or dispose or to direct the voting or disposition of the shares. The SEC concluded, "As a general

"Some people deliberately go close to the line dividing legal from illegal if they see a sufficient opportunity for profit in doing so. A few cross that line and, if caught, seek to justify their actions on the basis of formalistic arguments even when it is apparent that they have defeated the purpose of the law. This is such a case."

-- Judge Kaplan

matter, a person that does nothing more than enter into an equity swap should not be found to have engaged in an evasion of the reporting requirements."

The Court on the other hand stated that the definition of "beneficial ownership" is very broad and is not confined merely to the right to vote or dispose of securities. The Court found that TCI's ability to affect voting or investment power over the shares underlying the equity swaps would be exercised, and therefore TCI beneficially owned

those shares under the Rule 13d-3(a) definition of “beneficial ownership.” As a practical matter, the Court noted, TCI was aware that the counterparties to the swaps would hedge their positions by directly acquiring the shares. The Court noted that TCI also had the ability to unwind the swaps in kind, meaning that at the conclusion of each swap transaction the counterparties could have been required to deliver the referenced shares to TCI. The Court also found that TCI took specific steps to ensure that it would have greater control over the voting of the referenced shares, including concentrating its swap positions amongst “friendly” banks that it believed were more likely to vote with TCI in the proxy contest and amongst banks whose policies allowed TCI to request that the referenced shares not be voted against it in the proxy contest.

Ultimately, however, the Court determined that it was not necessary to make a ruling under the basic definition of beneficial ownership under Rule 13d-3(a). Instead, the Court, relying on Rule 13d-3(b), held that TCI beneficially owned the shares because of its plan or scheme to evade the reporting requirements of Section 13(d). Rule 13d-3(b), in relevant part, provides that a person is deemed to be the beneficial owner of securities if that person directly or indirectly creates or uses any contract or arrangement with the purpose of divesting such person of beneficial ownership of a security as part of a plan or scheme to evade the reporting requirements of Section 13(d). The Court held that based on the facts at hand, TCI used the equity swaps for the purpose of avoiding its disclosure obligations. Such facts included (i) a statement by TCI’s CFO to the Board of Directors of TCI that one of the benefits of equity swaps is “the ability to purchase without disclosure to the market or the company,” (ii) TCI emails discussing

the need to ensure counterparties to the swaps stayed below 5% ownership, and (iii) the admission by TCI that one of its motivations in avoiding disclosure was to avoid paying a higher price for shares of CSX.

The Court also found that the two hedge funds violated Section 13(d) for failing to file the required disclosure within 10 days of acquiring beneficial ownership of more than 5% of CSX shares and for failing to timely file a Schedule 13D after the group was formed. The Court, however, did not find that the defendants’ Schedule 13D disclosure was false or misleading. The Court enjoined TCI from further Section 13(d) violations, but declined to grant the more severe relief sought by CSX -- to preclude TCI from voting its shares at CSX’s upcoming 2008 annual meeting of shareholders.

Although it remains to be seen what the outcome of the case will be on appeal, we believe Judge Kaplan’s ruling will, unless overturned, impact how activist investors utilize and disclose swap arrangements in building positions in their portfolio companies. In the meantime, we note that the ruling did not have an effect on the voting recommendation provided by RiskMetrics Group – ISS Governance Services (“ISS”) on the matters to be voted on at CSX’s 2008 annual meeting of shareholders. ISS has recommended that CSX shareholders vote for four of the five dissident nominees, noting that in ISS’ opinion, “the court unfairly singles out TCI and 3G as part of a larger indictment of common industry practice. As such, the 13(d) swaps ‘issue’ does not impact our analysis of this proxy contest.”

Please feel free to contact any of the partners listed below if you would like to discuss this opinion or its potential ramifications.

Steve Wolosky
swolosky@olshanlaw.com

Ken Silverman
ksilverman@olshanlaw.com

Ron Berenblat
rberenblat@olshanlaw.com

This publication is issued by Olshan Grundman Frome Rosenzweig & Wolosky LLP for informational purposes only and does not constitute legal advice or establish an attorney-client relationship. In some jurisdictions, this publication may be considered attorney advertising.